

County of Los Angeles CHIEF EXECUTIVE OFFICE

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May 14, 2015

To:

Supervisor Michael D. Antonovich, Mayor

Supervisor Hilda L. Solis

Supervisor Mark Ridley-Thomas

Supervisor Sheila Kuehl Supervisor Don Knabe

From:

Sachi A. Hamai

Interim Chief Executive Officer

REPORT BACK ON PROPOSALS TO ADDRESS THE UNFUNDED LIABILITIES IN THE COUNTY RETIREE HEALTHCARE PROGRAM

On April 14, 2015, the Board of Supervisors (Board) instructed the Interim Chief Executive Officer (CEO), in collaboration with the Auditor-Controller (A-C), to report back with proposals for dealing with the unfunded liabilities for the County's pension and retiree health benefits, also known as other post-employment benefits (OPEB). In preparing this report, the CEO collaborated with the Auditor-Controller, Treasurer and Tax Collector (TTC), and the County's consulting actuary.

This report discusses generally accepted principles for financing pension and retiree health benefits, along with three general strategies or options to reduce the County's unfunded liabilities.

PUBLIC FINANCING PRINCIPLES

As the California Legislative Analyst's Office (LAO) reports, a fundamental principle of public finance holds that expenses should be paid in the period they are incurred. This is not only true for programs funded by the County, but also the many programs that the County operates for the federal and State governments, along with services to other municipalities and the public. For retirement and retiree health benefits, it means that an employer should establish a plan to pay the amount of money that actuaries estimate is necessary, combined with future investment earnings, to pay for benefits earned by employees in that year. This amount of money is referred to as the "normal cost."

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In addition to paying the normal cost, a plan should establish a payment schedule to reduce the existing unfunded actuarial accrued liability (UAAL) for benefits earned to date by current employees and retirees. The combination of the normal cost and UAAL is referred to as the annual required contribution (ARC). The ARC has been recognized as the unofficial measuring stick that indicates the effort governments are making to properly fund their pension and retiree health plans.

PENSION BENEFITS

Based upon the latest actuarial valuation of the County's pension plan, a UAAL of \$11.3 billion was reported to the LACERA Board of Investments, which reflects a funding ratio of 79.5 percent as of June 30, 2014. Consistent with California county retirement law and LACERA's funding policy, the County has continued to make its ARC payments to the pension fund each month. Since the County already has a generally accepted financing plan in place to address the UAAL in its pension plan, we believe that no additional steps need to be taken at this time.

In addition to making the ARC payment for pensions, the County also instituted pension reforms in the late 1970's similar to those that the State and local governments more recently enacted. In the early 2000's, governmental agencies across the State began enhancing retirement benefits as a result of changes in retirement laws. However, the Los Angeles County Board of Supervisors held firm and resisted pension increases. All of these actions have helped restrain the County's pension obligation.

RETIREE HEALTHCARE BENEFITS

Background

Unlike the County pension benefits that are prefunded, retiree healthcare benefits have been financed on a pay-as-you-go basis, which means that the County pays for current-year retiree health expenses as they become due. This pay-as-you-go approach has led to the accumulation of an unfunded liability, which was last valued at \$27 billion in June 2013. The next valuation of this liability is expected to be released in June 2015. Prior to 2007, State and local governments were not required to measure or report the costs associated with these unfunded benefits on their financial statements. In many cases, the magnitude of the liabilities associated with this benefit was unknown.

New governmental accounting rules are designed to provide greater transparency as to the full costs of the promised benefits. These rules have prompted many public sector entities to begin exploring ways of managing their unfunded liabilities. Over the past two decades, the County's retiree healthcare program's annual cost has increased from \$115 million in Fiscal Year (FY) 1996-97, to a projected \$500 million in FY 2015-16, a 334 percent increase or an average annual increase of 8 percent. By 2020-21, we estimate that these costs could reach \$794 million, without any action to prefund the retiree health program.

Actions Taken by the County to Address the Retiree Healthcare Unfunded Liability

Since 2012, the County has taken several steps to mitigate the growing cost of this liability. Specifically, on May 15, 2012, the Board authorized the CEO to establish an OPEB trust fund to serve as a vehicle for holding and investing assets to prefund the Retiree Healthcare Plan. As a result, the CEO transferred a total of \$448 million into the OPEB trust fund in FY 2013-14. The market value of the trust fund has increased approximately six percent to \$476 million as of December 2014.

On May 15, 2012, the Board also directed the CEO to revise Board Policy 4.030 – Budget Policies and Priorities related to excess retiree health premium reserves. The revised policy requires the CEO to direct LACERA to transfer the County's share of the excess retiree health premium reserves to the OPEB trust fund if the reserve account exceeds the prudent reserve level established by LACERA.

Furthermore, on June 17, 2014, the Board authorized a new retiree health insurance program for new County employees hired after June 30, 2014 and eligible for LACERA membership. The program, titled the Los Angeles County Retiree Healthcare Benefits Program – Tier 2 (Tier 2), offers reduced benefits covering hospital services, medical services, and dental/vision services to County retirees and their eligible dependents. Tier 2 is expected to save the County over \$800 million and to reduce the unfunded liability by 20 percent over a thirty-year period.

The County's actions to address the growing OPEB liability have been viewed as a necessary first-step by the three major credit rating agencies. In a December 2014 ratings report, Fitch Ratings stated that it "views the OPEB funding effort as positive but modest and recognizes the County has a funding challenge" with respect to OPEB. Similarly, Moody's Investor Services has cautioned that "the looming burden of OPEB liabilities" is a potential long-term risk for the County's rating. Standard & Poor's has likewise expressed these same concerns regarding future cost pressures, and it is certain that the issue of OPEB liabilities will remain a key credit issue with each of the rating agencies.

Options for Addressing the Retiree Healthcare Unfunded Liability

Outlined below are three (3) general strategies or options for reducing the unfunded liability:

- 1. Prefund Retiree Healthcare Benefits
- 2. Change the Retiree Healthcare Benefit Structure; and
- 3. Issue OPEB Bonds in the Capital Market.

1. <u>Prefund Retiree Healthcare Benefits</u>

Prefunding retiree healthcare benefits would require the County to begin making ARC payments. Based upon information provided by our consulting actuary, the ARC for retiree health benefits is estimated to be approximately \$2.2 billion annually in 2014-15. Since the County currently contributes approximately \$500 million on an annual basis for the pay-as-you-go costs, this would require an additional contribution of \$1.7 billion annually to reach the ARC. To achieve this level of funding, as well as continuing to maintain the current service levels to County residents, would require the County to utilize a multi-year strategy to phase in the prefunding portion of this benefit, while continuing to make the pay-as-you-go contribution to LACERA.

Using a multi-year approach to increase the County retiree health payment each year in a consistent manner, we asked our consulting actuary to model three (3) different methodologies. Each scenario estimates a total contribution that could be made toward reaching the ARC. The assumptions incorporate an annual net County cost (NCC) amount along with a subvention contribution. The subvention contribution is assumed since the County administers many federal and State programs, along with services to other municipalities and the public, and receives revenue to offset the cost of running those programs. If the County were to begin prefunding this benefit, we could leverage our County contribution with subvention funding. The chart below depicts how many years it would take to fully fund the ARC and the estimated funding level in the OPEB Trust Fund by the year 2054. The model also assumes that the County would continue to make its pay-as-you-go payments, which grow at approximately 9.5 percent and is consistent with the latest retiree health valuation. The chart also demonstrates that a prefunding plan will result in cash flow savings given that excess monies in the OPEB Trust Fund can be utilized to offset pay-as-you-go costs in the years following when the ARC is fully funded. Gross cash flow savings to the County were estimated by the consulting actuary to be between \$14 billion and \$65 billion over a 40-year period of pre-funding.

Scenario	Additional Net County Cost (NCC) Contribution each Year	Additional Subvention Contribution each Year	Additional Total Contribution each Year	Projected Year ARC is Fully Funded	Percent Funded in 2054	Net Cash Savings over 40 Years	Present Value of Net Cash Savings
A	\$10 Million	\$12 Million	\$22 Million	2034	32%	\$14 Billion	\$ 4 Billion
В	\$25 Million	\$31 Million	\$56 Million	2027	43%	\$35 Billion	\$11 Billion
С	\$50 Million	\$62 Million	\$112 Million	2022	50%	\$65 Billion	\$23 Billion

2. Change the Retiree Healthcare Benefit Structure

Any changes to the Retiree Healthcare benefit structure would have to be viewed separately between retiree/current employees and future employees.

• Change the Benefit Structure for Retiree and Current Employees

In 1982, the County entered into an agreement with LACERA to provide retiree healthcare benefits. County Employee Retirement Law (CERL) section 31692 made this contractual obligation a statutory one. The County is different from most other jurisdictions since CERL 31692 extends the vested rights doctrine upon appointment to retiree healthcare, not only pension benefits. Therefore, any changes to retiree healthcare for active employee or retired employees is risky and would likely result in legal action.

• Changes to the Benefit Structure of Retiree Healthcare for Future Employees

All employees hired after July 1, 2014 are under Tier 2 of retiree healthcare program. The basic change for Tier 2 employees is the guaranteed benchmark plan at the employee only rate, rather than at the family rate for Tier I employees. Tier II also requires enrollment into Medicare. Tier II did not change the funding structure of retiree healthcare, meaning the County is still obligated to fund the benefit.

The County could negotiate a third-plan tier with labor and LACERA. Additional cost curtailing options include:

- Change the funding structure to require employees to equally share the normal cost of prefunding of their retiree healthcare benefit, similar to the new pension-funding standard.
- Further, limit the benefit design for new employees, such as changing to a defined contribution type plan whereby retirees would be given a fixed amount of money to purchase their benefits. This option allows the County to control costs rather than being tied to the cost of the healthcare coverage.
- Lower the percentage of single coverage paid by the County, such as 50 percent of the benefit paid by the County and 50 percent paid by the retiree.

3. Issue OPEB Bonds in the Capital Market

We reviewed the issuance and sale of OPEB bonds as a potential means for local governments to reduce their unfunded liability. Utilizing this structure, the County would sell taxable bonds in the capital markets and deposit the proceeds into the OPEB Trust as a means of pre-funding the long-term liability. The chief risk associated with OPEB bonds is that the trust fund must realize investment returns greater than the borrowing

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cost of the bonds in order not to incur a monetary loss on the financing. Furthermore, market acceptance of OPEB bonds remains uncertain and would require that the County undertake judicial validation proceedings in California Superior Court. Based upon these risks, neither the CEO nor the TTC support the issuance of OPEB bonds.

This report provides the Board with several options to reduce the County's unfunded liability for retiree healthcare benefits.

We plan to return to Board with specific recommendations to address this liability during the Final Changes Budget phase of the FY 2015-16 budget process in June 2015.

If you have any questions, or need additional information, your staff may contact Maryanne Keehn (213) 974-0470, or Matthew McGloin at (213) 974-1694.

SAH:JJ:SK: MK:MM:TO:yjf

c: Executive Officer, Board of Supervisors
County Counsel
Auditor-Controller
Treasurer and Tax Collector